Supreme Court of the United States

OCTOBER TERM, 1946.

No. 209.

ADAM A. ADAMS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF ON BEHALF OF PETITIONER.

SYDNEY A. GUTKIN,
Attorney for and of Counsel with Petitioner,
744 Broad Street,
Newark 2, New Jersey.

INDEX.

	PAGE
OPINIONS OF THE COURTS BELOW	1
JURISDICTION	1
STATEMENT OF THE CASE	2
SPECIFICATION OF ASSIGNED ERRORS INTENDED TO BE URGED	6
SUMMARY OF THE ARGUMENT	7
THE ARGUMENT	10
POINT I.—The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend in spite of the Tax Court's finding of fact that the Corporation's surplus account was not affected conflicts with the prevailing authority established by the United States Circuit Court of Appeals for the First Circuit on the same matter. In fact, the Tax Court admittedly flouted the First Circuit Court's precedent in arriving at its decision in the instant case	10
POINT II.—The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 112(b)(2), 112(c)(1) and 112(e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112(b)(3), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss. The presence of loss distinguishes the instant cause from *Bazley* v. *Commissioner*, 155 F. (2d) 237 (C. C. A. 3rd, 1946)	15

PAGE

POINT III.—The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein must have a corporate business purpose (as distinguished from a shareholder purpose) to be within Sections 112(g)(1) (E) and 112(b)(3) is interstitial legislation injecting a new requirement into the statute. Said requirement is an unwarranted extension of authority established by this Court in *Gregory* v. *Helvering*, 293 U. S. 465 (1935) 18

A. The exchange herein involved falls within the exact tenor of Section 112(b)(3). Where a statute is clear and unambiguous on its face, resort to extraneous materials for the purpose of interpreting it is improper 19

B. The legislative history of the reorganization sections herein involved and pertinent decisions clearly show that a corporate business purpose as distinguished from a shareholder purpose is not required 22

C. The instant plan of reorganization was adopted and effectuated for legitimate business purposes, including corporate and shareholder purposes. The Tax Court found such purposes to be present herein 34

POINT IV.—There is no basis for the holding of the Third Circuit Court, affirming the decision of the Tax Court, that the reorganization herein gave rise to a distribution essentially equivalent to the distribution of a taxable dividend under Section 115(g) of the Internal Revenue Code 39

A. The legislative history of Sections 112(b)(3) and 115(g) furnishes proof that the instant transaction is not governed by Section 115(g) 40

PAGE

B. The law and the applicable regulations demonstrate that the instant transaction cannot be governed by Section 115(a) 44

C. Judicial precedents with respect to Sections 112(b)(3) and 115(g) illustrate the inapplicability of Section 115(g) to the instant transaction 45

D. Section 115(g) is essentially a liquidation provision, thereby being inapplicable herein 47

E. The application of Section 115(g) to the instant transaction distorts the facts herein as well as the intention of the parties 47

POINT V.—The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 111, 112(a) and 117 of the Internal Revenue Code. Under these sections, even if the exchange was one upon which gain or loss was recognized, the petitioner sustained a loss as a result thereof. Accordingly, petitioner overpaid his tax for the year 1941 49

POINT VI.—The holding of the Circuit Court of Appeals for the Third Circuit, affirming the decision of the Tax Court, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court 52

CONCLUSION 53

APPENDIX 54

CASES CITED.

	PAGE
Adler, Leopold, 30 B. T. A. 897 (1934), aff'd 77 F. (2d) 733 (C. C. A. 5th, 1935)	43
Ahles Realty Corp. v. *Commissioner*, 71 F. (2d) 150 (C. C. A. 2nd, 1934), cert. den. 293 U. S. 611, 55 S. Ct. 141 (1934)	20
Annis Furs, Inc., 2 T. C. 1096 (1943)	20, 21, 35, 36, 46
Bass, Edith B., 45 B. T. A. 1117 (1941)	11
Bass v. *Commissioner*, 129 F. (2d) 300 (C. C. A. 1st, 1942)	7, 11, 14, 20, 21
Bazley v. *Commissioner*, 155 F. (2d) 237 (C. C. A. 3rd, 1946)	7, 10, 16, 19, 30
Brown, Charles R., 7 T. C. No. 86 (Docket No. 9146, September 10, 1946)	21
Chisholm v. *Commissioner*, 79 F. (2d) 14 (C. C. A. 2nd, 1935), cert. den. 296 U. S. 641, 56 S. Ct. 174 (1935)	24, 25
Commissioner v. *Capento Securities Corporation*, 140 F. (2d) 382 (C. C. A. 1st, 1944), aff'g 47 B. T. A. 691 (1942)	20, 21
Commissioner v. *Court Holding Co.*, 324 U. S. 331, 65 S. Ct. 707 (1945)	8, 26
Commissioner v. *Day & Zimmerman*, 151 F. (2d) 517 (C. C. A. 3rd, 1945)	35
Commissioner v. *Estate of Bedford*, 325 U. S. 283, 65 S. Ct. 1157 (1945)	8, 13, 47
Commissioner v. *Gilmore's Estate*, 130 F. (2d) 791 C. C. A. 3rd, (1942)	26
Commissioner v. *Kelley Co.*, 146 F. (2d) 466 (C. C. A. 7th, 1944)	52
Commissioner v. *Kolb*, 100 F. (2d) 920 (C. C. A. 9th, 1938)	20
Commissioner v. *Neustadt's Trust*, 131 F. (2d) 528 (C. C. A. 2nd, 1942)	20
Commissioner v. *Wheeler*, 324 U. S. 542, 65 S. Ct. 799 (1945)	13

PAGE

Dobson v. *Commissioner*, 320 U. S. 489, 64 S. Ct. 239 (1943) 9, 34, 53

Docherty, Edgar M., 47 B. T. A. 462 (1942) 20, 21, 30

Doerschuck v. *United States*, 274 Fed. 739 (D. C. E. D. N. Y., 1921) 12

Eisner v. *Macomber*, 252 U. S. 189, 40 S. Ct. 189 (1920) 9, 11, 42, 44, 52

Electrical Securities Corp. v. *Commissioner*, 92 F. (2d) 593 (C. C. A. 2nd, 1937) 26

Fischer, Jacob, 46 B. T. A. 999 (1942) 21, 46

Gregory v. *Helvering*, 293 U. S. 465, 55 S. Ct. 266 (1935) 8, 18, 22, 24, 25, 26, 27, 28, 29, 33

Griffiths v. *Commissioner*, 308 U. S. 355, 60 St. Ct. 277 (1939) 26

Helvering v. *Gowran*, 302 U. S. 238, 58 S. Ct. 154 (1937) 13

Helvering v. *Griffiths*, 318 U. S. 371, 63 S. Ct. 636 (1943) 9, 14, 52

Helvering v. *Minnesota Tea Co.*, 296 U. S. 378, 56 S. Ct. 269 (1935) 26

Helvering v. *Minnesota Tea Co.*, 89 F. (2d) 711 (C. C. A. 8th, 1937) aff'd 302 U. S. 609, 58 S. Ct. 393 (1938) 20

Helvering v. *Southwest Consolidated Corporation*, 315 U. S. 194, 62 S. Ct. 546 (1942) 20

Hill, Annie Watts, 27 B. T. A. 73 (1932), aff'd 66 F. (2d) 45 (C. C. A. 4th, 1933) 43

Johnston, J. D., Jr., 3 T. C. 799 (1944) 26

Kelley Co. v. *Commissioner*, 326 U. S. 521, 66 S. Ct. 299 (1946) 8, 27

Leland v. *Commissioner*, 50 F. (2d) 523 (C. C. A. 1st, 1931) 14

LeTulle v. *Scofield*, 308 U. S. 415, 60 S. Ct. 313 (1940) 21

PAGE

Lusthaus v. *Commissioner*, 327 U. S. 293, 66 S. Ct. 539 (1946) 8, 26

McCord, H. Y., 31 B. T. A. 342 (1934) 45
Meurer Steel Barrel Co. v. *Commissioner*, 144 F. (2d) 282 (C. C. A. 3rd, 1944) 35
Moyer, W. W., 35 B. T. A. 1155 (1937) 26
Munroe, C. A., 39 B. T. A. 685 (1939) 35

National Investors Corp. v. *Hoey*, 144 F. (2d) 466 (C. C. A. 2nd, 1944) 26

Peabody v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546 (1918) 12

Scherer, Robert P., 3 T. C. 776 (1944) 26
Schoo, Clarence J., 47 B. T. A. 459 (1942), Commissioner's Appeal dismissed, (C. C. A. 1st, 1943) 20, 21, 35
Shenandoa Rayon Corporation, 42 B. T. A. 1287 (1940), aff'd. 122 F. (2d) 268 (C. C. A. 2nd, 1941) 46
Smith, M. W., Jr., 3 T. C. 894 (1944) 26
South Atlantic Steamship Line, 42 B. T. A. 704 (1940) 46
Starr v. *Commissioner*, 82 F. (2d) 964 (C. C. A. 4th, 1936), cert. den. 298 U. S. 680, 56 S. Ct. 948 (1936) 20
Strassburger v. *Commissioner*, 318 U. S. 604, 63 S. Ct. 791 (1943) 9, 52

Tower v. *Commissioner*, 327 U. S. 280, 66 S. Ct. 532 (1946) 8, 26, 35

Wellhouse, Louis, Jr., 3 T. C. 363 (1944) 19, 45

Zukaitis, Felix, 3 T. C. 814 (1944) 26

CONSTITUTION, STATUTES AND REGULATIONS.

Constitution of the United States:
Sixteenth Amendment 9, 54

PAGE

Revenue Acts of 1918, 1921:
Section 201 42
Section 202 ..... 40, 41

Revenue Acts of 1924, 1926:
Section 201 ..... 42, 43
Section 203 40

Revenue Act of 1928:
Section 112(g) 23
Section 112(i) 23

Internal Revenue Code:
Section 22 ..... 9, 52, 54
Section 111 ..... 7, 9, 49, 54
Section 112(a) 7, 9, 49, 55
Section 112(b)(2) 6, 7, 9, 15, 16, 17, 18, 49, 55
Section 112(b)(3) 6, 7, 8, 9, 15, 17, 18, 19, 21 22, 23, 33, 37, 40, 45, 46, 49, 55
Section 112(c)(1) 6, 7, 15, 16, 17, 55
Section 112(e) 6, 7, 9, 15, 16, 17, 18, 49, 56
Section 112(g) 6, 8, 9, 18, 19, 22, 23, 45, 46, 56
Section 115(a) 8, 10, 11, 28, 44, 56
Section 115(b) 14, 56
Section 115(c) 44, 51, 57
Section 115(g) 8, 11, 39, 40, 41, 43, 45, 46, 47, 49, 57
Section 117 ..... 7, 9, 49, 57

Judicial Code of United States, 43 Stat. 938, Sec. 240(a) (U. S. C. A., Title 28, Sec. 347) 2

PAGE

Revised Statutes of New Jersey (1937):

Title 14, Chapter 8, Section 19 ..... 14, 57

Title 14, Chapter 11, Section 1 ..... 18, 58

Title 14, Chapter 11, Section 2 ..... 18, 58

Regulations 103:

Section 19:115-1 44

COMMITTEE REPORTS

Senate Finance Report, Revenue Bill of 1918, 1939-1 C. B. (2) 117 40

Senate Finance Report, Revenue Bill of 1921, 1939-1 C. B. (2) 181 ..... 41, 43

Ways & Means Report, Revenue Bill of 1921, 1939-1 C. B. (2) 168 41

Senate Finance Report, Revenue Bill of 1924, 1939-1 C. B. (2) 266 ..... 41, 43

Ways & Means Report, Revenue Bill of 1924, 1939-1 C. B. (2) 241 ..... 41, 43

Ways & Means Report, Revenue Bill of 1934, 1939-1 C. B. (2) 554 22

ARTICLES

Sydney A. Gutkin and David Beck, "Stock Redemptions as Taxable Events Under Section 115(g): The Impressionistic Test", Journal of Accountancy, October, 1945 46

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 209

ADAM A. ADAMS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF ON BEHALF OF PETITIONER.

Opinions of the Courts Below.

The original opinion of the Tax Court of the United States in this proceeding was promulgated on April 26, 1945. It is reported at 4 T. C. 1186 and is printed in the Record at page 83 a.

The superseding opinion of the Tax Court of the United States in this proceeding was promulgated on June 29, 1945. It is reported at 5 T. C. 351 and is printed in the Record at page 95 a.

The opinion of the United States Circuit Court of Appeals for the Third Circuit was promulgated on April 16, 1946. It is reported at 155 F. (2d) 246 (C. C. A. 3rd, 1946) and is printed in the Record at page 114 a.

Jurisdiction.

1. The date of the judgment of the Circuit Court of Appeals for the Third Circuit to be reviewed was April 16, 1946.

2. Petition for Writ of Certiorari was filed on June 18, 1946.

3. The jurisdiction of the Court to issue the writ of certiorari was invoked under Judicial Code, Section 240(a), as amended by the Act of February 13, 1925, 43 Stat. 938 (U. S. C. A., Title 28, Section 347).

4. The Order of this Court allowing certiorari was filed on October 14, 1946.

Statement of the Case.

1. The facts as found by the Tax Court are as follows:

The petitioner, Adam A. Adams, is an individual, presently residing at 231 Elmwynd Drive, Orange, New Jersey. He filed an income tax return for the calendar year in question with the collector of internal revenue for the fifth district of New Jersey (R. 32a, 96a; Par. 1 of Petition, admitted by Answer).

The Newark Theatre Building Corporation (hereinafter referred to as the Corporation) is a corporation of New Jersey (Petitioner's Exhibit 1, R. 8a, 96a). Prior to December 6, 1940, said Corporation had an authorized capital stock of 6,000 shares of common stock, each of the par value of $100.00 (Petitioner's Exhibits 1, 3, R. 8a, 11a). Of such authorized par value stock, there were issued and outstanding, at said date and until January 27, 1941, 5,914 shares, of which petitioner was the owner and holder of 5,903 shares (R. 10a, 11a, 30a, 96a).

On December 6, 1940, a plan of recapitalization was adopted by the stockholders of the Corporation to reduce the aggregate par value of the authorized capital stock from $600,000.00 to $295,700.00, to be divided into 5,914 shares of stock of no par value (but of a stated value of $50 each),

and to issue 6%, twenty-year debenture bonds, in the aggregate principal sum of $295,700.00 (Petitioner's Exhibit 2, R. 62a-68a, 9a, 11a, 96a-97a). Said plan provided, furthermore, for the issuance by the Corporation of one no par value share and one $50.00 debenture bond in exchange for each $100.00 par value share of stock which it had outstanding (Petitioner's Exhibit 2, R. 62a-68a, 9a, 11a, 97a).

The plan to recapitalize was adopted for several reasons. Among such reasons were the savings in federal income and state franchise taxes to be effected thereby (R. 10a-11a, 20a, 35a, 97a). The Corporation accomplished the former by deducting interest payments on the debentures (R. 21a, 97a). The Corporation accomplished the latter by a reduction of its outstanding stock, resulting in an annual saving in excess of $400.00 (R. 10a, 30a, 98a). To be exact, it has saved $413.98 each year and will so save in each year of its existence (R. 30a). The legal fees paid with respect to effecting the recapitalization amounted to $759.44 (R. 20a).

In addition, the recapitalization was undertaken because Mr. Adams desired to give some bonds to members of his family without surrendering any of his stock control over the company (R. 21a, 33a, 102a-103a).

The foregoing plan of recapitalization was carried out in exact accordance with its terms (R. 12a, 98a). Pursuant thereto, on January 27, 1941, petitioner surrendered to the Corporation his 5,903 shares, the shareholders of the other 11 outstanding certificates did likewise, and in exchange therefor new certificates and debentures of the type called for by the plan were issued to them (R. 11a, 12a, 98a, Petitioner's Exhibits 4, 5, R. 69a, 70a-71a). The Corporation's capital stock account was written down from $591,400.00 to $295,700.00 (R. 18a, 98a), the balance was credited to debentures (R. 18a, 98a), and its certificate of incorporation was amended, pursuant to the plan of reorganization (Peti-

tioner's Exhibit 6, R. 17a, 72a-78a). No entries or changes were made with respect to the surplus account (R. 18a, 98a, Petitioner's Exhibits 7, 8, R. 79a-82a). Nor was there any intent on the part of the Corporation to take anything out of surplus or to declare a dividend (R. 19a). And it was found as a fact by the Tax Court that: "The surplus account was not affected" (R. 86a, 98a).

The earnings and profits of the Corporation accumulated since February 28, 1913, and up to December 31, 1940, were $157,225.05, and up to December 31, 1941, were $164,874.47, of which $111,596 had been capitalized by stock dividends declared in prior years (R. 13a, 27a, 98a, Petitioner's Exhibit 7, R. 18a, 79a-80a). The accumulated earnings and profits of the corporation available for distribution on January 26, 1941, were not less than $164,514.82 (R. 101a).

The debentures regularly earned and paid the interest due on them (R. 101a).

2. The facts established at the hearing of the instant cause, but with respect to which the Tax Court neglected and omitted to make findings, relate to petitioner's cost basis of his 5,903 shares and the fair value of the property received by him in exchange therefor. However, as hereinafter indicated, important federal questions of law which were raised before, and not passed upon by, the United States Circuit Court of Appeals for the Third Circuit with respect to other issues herein involved, turn upon such facts and would appear to make imperative a remand of the case to the Tax Court with instructions to make further findings of fact, if the Circuit Court is not reversed upon any issue herein involved.

The testimony at the hearing of the instant cause is clear that petitioner's 5,903 shares were acquired by him

at various times prior to the reorganization, at an aggregate adjusted cost to him of $417,944.28 (R. 16a, 17a, 21a, 30a). Said cost basis had its roots in petitioner's initial investment in certain partnership assets (R. 14a, 22a, 27a, 28a) and subsequently in successor corporations, all testimony with respect to which was minutely developed at the hearing (R. 14a-25a, inclusive).

The testimony is equally clear that the fair value of the property received in exchange by petitioner for his 5,903 shares of stock was $272,086.69 (R. 44a-58a, inclusive). Accordingly, petitioner realized a loss of $145,857.59 upon the exchange.

3. The case was tried in the Tax Court before Judge Kern, who made findings of fact and rendered an opinion (promulgated on April 26, 1945) in favor of the petitioner.

Subsequently, and pursuant to an order of Judge Murdock, dated May 1, 1945, the case was referred by him to the entire Court for review. Thereupon, the earlier decision was reversed by a divided court, the majority opinion being written by Judge Opper. Said opinion was promulgated on June 29, 1945. Judges Arundell, Smith, Black, Hill and Kern dissented. Two separate dissenting opinions were filed.

On September 6, 1945, petitioner filed with the Clerk of the Tax Court of the United States a petition for review by the United States Circuit Court of Appeals for the Third Circuit of the decision of the Tax Court. Said cause was argued before the Circuit Court of Appeals on February 7, 1946, before Judges Maris, Goodrich and O'Connell. On February [illegible]946, the Circuit Court, on its own motion, ordered the case restored to the argument list for re-argument before the court *en banc*. The case was re-argued on March 5, 1946 before Judges Biggs, Maris,

Goodrich, McLaughlin and O'Connell. The opinion of the Circuit Court was filed on April 16, 1946. Judges Maris and Goodrich filed a dissenting opinion.

Specification of Assigned Errors Intended to be Urged.

1. The Circuit Court of Appeals for the Third Circuit erred in holding that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend where the Tax Court found as a fact that the corporation's surplus account was not affected.

2. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to consider the Federal questions of law involved in Sections 112(b)(2)*, 112(c)(1), and 112(e) of the Internal Revenue Code, all of which were raised in petitioner's briefs and oral argument, and in failing to hold that there was no taxable income to be recognized upon the exchange herein.

3. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to find that the petitioner sustained a loss.

4. The Circuit Court of Appeals for the Third Circuit erred in holding that a recapitalization within Sections 112(g)(1)(E) and 112(b)(3) of the Internal Revenue Code must have a corporate business purpose.

---

* All sections of the Internal Revenue Code herein referred to are set forth in the Appendix, attached hereto.

5. The Circuit Court of Appeals for the Third Circuit erred in failing to hold that the recapitalization herein had a corporate business purpose.

6. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to consider the Federal questions of law involved in Sections 111, 112(a) and 117 of the Internal Revenue Code, all of which were raised in petitioner's briefs and oral argument, and in failing to hold that there was no taxable income to be recognized upon the exchange herein.

7. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in holding that the petitioner realized income.

Summary of the Argument.

POINT I. Inasmuch as the Tax Court found as a fact that the surplus account of the corporation was not affected by the recapitalization herein, the instant case is controlled by precedent laid down in *Bass* v. *Commissioner*, 129 F. (2d) 300 (C. C. A. 1st, 1942), that there can be no distribution of a taxable dividend under such circumstances. The constancy of the corporation's surplus account distinguishes the case at bar from *Bazley* v. *Commissioner*, 155 F. (2d) 237 (C. C. A. 3rd, 1946), cert. granted October 14, 1946.

POINT II. If gain or loss is not precluded by the application of Section 112(b)(3), which is denied, then under Sections 112(b)(2), 112(c)(1) and 112(e), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss. The presence of loss distinguishes the case at bar from *Bazley* v. *Commissioner*, *supra*. Should this Court not reverse the

Third Circuit upon any other issue herein involved, it is submitted that this Court should remand the cause to the Tax Court for further findings with respect to such loss.

POINT III. There is no requirement in the statute, the legislative history, or case law that a corporate business purpose as distinguished from a shareholder purpose is necessary to bring a recapitalization exchange within Sections 112(g)(1)(E) and 112(b)(3). The holding of the Third Circuit Court requiring a corporate business purpose is interstitial legislation, and is an unwarranted extension of *Gregory* v. *Helvering*, 293 U. S. 465, 55 S. Ct. 266 (1935). This is evidenced by this Court's interpretation of the *Gregory* rule in *Tower* v. *Commissioner*, 327 U. S. 280, 66 S. Ct. 532 (1946); *Lusthaus* v. *Commissioner*, 327 U. S. 293, 66 S. Ct. 539 (1946); *Commissioner* v. *Court Holding Company*, 324 U. S. 331, 65 S. Ct. 707 (1945); *John Kelley Company* v. *Commissioner*, 326 U. S. 521, 66 S. Ct. 299 (1946). Even if a corporate business purpose is required, the Tax Court has made findings of fact which demonstrate that such purpose exists herein.

POINT IV. There is no basis in the statute, legislative history, case law, or facts to substantiate the holding of the Third Circuit Court that the recapitalization herein gave rise to the distribution of a taxable dividend under Section 115(g). Nowhere does it appear that Congress intended Section 115(g) to apply to recapitalizations or to situations where a corporation's own bonds were issued in connection therewith. Nor can such recapitalization be governed by Section 115(a). The holding of the Third Circuit Court takes a Section 112 transaction out of the compass of that section and forces it into the mold of Section 115, in direct violation of language of this Court. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, 65 S. Ct. 1157 (1945).

POINT V. If the instant exchange is not a tax-free reorganization within Sections 112(b)(3) and 112(g)(1)(E), upon which gain or loss is not recognized, or if it is not considered a boot transaction upon which there is loss, said loss not being recognized pursuant to Sections 112(b)(2) and 112(e), then such exchange is one upon which gain or loss is recognized, subject to treatment as a capital gain or loss, pursuant to Sections 111, 112(a) and 117. Accordingly, petitioner sustained a loss, which is deductible as a long-term loss, and is entitled to a refund in tax approximating $20,000.00.

POINT VI. The holding of the Third Circuit Court, to the effect that petitioner *realized* any income, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court. *Eisner* v. *Macomber*, 252 U. S. 189, 40 S. Ct. 189 (1920); *Strassburger* v. *Commissioner*, 318 U. S. 604, 63 S. Ct. 791 (1943); *Helvering* v. *Griffiths*, 318 U. S. 371, 63 S. Ct. 636 (1943). There is no principle of law which compels the Tax Court to find taxable income in a transaction where as a matter of fact there is no economic gain. *Dobson* v. *Commissioner*, 320 U. S. 489, 64 S. Ct. 239 (1943).

THE ARGUMENT.

POINT I.

The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend in spite of the Tax Court's finding of fact that the Corporation's surplus account was not affected conflicts with the prevailing authority established by the United States Circuit Court of Appeals for the First Circuit on the same matter. In fact, the Tax Court admittedly flouted the First Circuit Court's precedent in arriving at its decision in the instant case.

Under Section 115 (a) of the Internal Revenue Code a dividend is any *distribution* by a corporation to its shareholders, whether in money or property, either out of *accumulated earnings and profits or earnings and profits of the taxable year.* The facts herein clearly indicate there was no *intent on the part of the Corporation to declare a dividend; that no entries or changes were made with respect to the surplus account, that there was no "distribution" of money or other property, and that petitioner's aggregate wealth was in no way increased.* Moreover, *the Tax Court found as a fact that the surplus account was not affected,* and this clearly distinguishes the instant cause from *Bazley v. Commissioner, supra.*

It is a fundamental accounting principle that dividends, if declared and paid, must come from some surplus account, whether it be earned and available or otherwise. It is a fundamental principle of tax and corporation law that every dividend involves, in the first instance, a segregation

out of surplus account of a definite portion of the corporate earnings and profits available for dividends, thereby making such profits unavailable for future distribution at the discretion of the directors. It would be a contradiction in terms to say that there has been a "distribution" out of "earnings or profits" when such earnings and profits have been left intact and available for dividend distributions in the future. Aside from the constancy of the Corporation's surplus account in the accounting sense, there was, in the economic sense, as much available for future dividend distributions subsequent to the exchange as prior thereto. It is submitted that there could not have been any such distribution of earnings and profits as is envisaged by Sections 115 (a) or 115 (g) of the Code.

The foregoing principles have been forcefully enunciated by the Circuit Court of Appeals for the First Circuit in *Bass* v. *Commissioner, supra*, in its reversal of the decision of the Board of Tax Appeals in *Edith B. Bass*, 45 B. T. A. 1117 (1941), and there can be no doubt that had the case at bar arisen in the First Circuit, the result herein would have been different from that reached by the Third Circuit.

The First Circuit Court, relying upon *Eisner* v. *Macomber, supra*, stated that even a stock dividend required a segregation out of surplus account of a definite portion of corporate earnings or profits theretofore available for dividends, the freezing of such segregated earnings as part of the permanent capital resources of the corporation by the device of capitalizing the same, and the issuance to the stockholders of additional shares of stock representing the profits so capitalized. The court then stated that if "profits are capitalized by means of a stock dividend such profits are no longer available for the declara-

tion of a dividend at the discretion of the directors but become part of the permanent capital of the corporation, thereby tending to enhance the corporation's credit. If profits are not capitalized they may be distributed as dividends some time in the future; and it would be a contradiction in terms to say there has been in any sense a 'distribution' out of 'earnings or profits' when such earnings have been expressly held intact in the surplus account for possible future distribution" (p. 305).

The Tax Court recognized the precedent set by the First Circuit Court, but chose to ignore appellate authority with a statement that with "the greatest deference, however, we remain of the opinion that the decision of the Board of Tax Appeals in that case was correct, and we feel obliged to adhere to it rather than to follow the reasoning of the opinion of reversal". The majority of the Tax Court cited in this connection and relied upon, *Doerschuck* v. *United States,* 274 Fed. 739 (D. C. E. D. N. Y., 1921) and *Peabody* v. *Eisner,* 247 U. S. 347, 38 S. Ct. 546 (1918), neither of which is applicable herein. In the *Doerschuck* case, a corporation voted an issue of $738,000.00 of debenture bonds *from its surplus account,* and said bonds came into the hands of plaintiffs in the proportion of their stockholdings. There was no reorganization involved. The Court found that the plaintiffs received an actual payment of profits which the company wished to distribute as earnings to its stockholders. In the *Peabody* case, there was a *declaration of a dividend* by a corporation and the payment of such dividend by cash and stock held by it in a second corporation. Thus, there was a dividend *distribution in specie.* No reorganization was involved. Neither of these cases stands for anything more than the general proposition that a dividend distribution may take the form

of property other than money. Obviously, said cases have no bearing on the issue before this Court.

Nor has the conflict of opinion between the Circuit Courts of Appeals for the First and Third Circuits in any way been alleviated or resolved by the decisions of this Court which the Third Circuit cited in support of the collateral proposition that corporate accounting concepts do not control tax incidents, e. g. *Commissioner* v. *Estate of Bedford*, *supra*; *Commissioner* v. *Wheeler*, 324 U. S. 542, 65 S. Ct. 799 (1945); *Helvering* v. *Gowran*, 302 U. S. 238, 58 S. Ct. 154 (1937). Petitioner concedes that mere bookkeeping entries should not be conclusive with respect to tax consequences, but submits that none of the cases cited by the Third Circuit Court of Appeals furnish any precedent for its holding herein that the exchange amounted to a distribution essentially equivalent to a dividend. In the *Bedford* case, the taxpayer, in connection with a recapitalization, exchanged his preferred stock for other preferred stock and common stock of the same corporation, *and cash*. Admittedly, the recapitalization was a tax-free exchange, the sole issue being whether the cash distribution was taxable as a dividend or a capital gain. In the *Gowran* case, a *dividend had been declared* on common stock, payable in preferred stock. The question there concerned the taxation as income of the preferred stock dividend and the proceeds received on the sale thereof. In the *Wheeler* case, the issue involved the proper basis to be used to compute, pursuant to Section 112(b)(7) of the Revenue Act of 1938, the amount of "earnings and profits" distributed as liquidating dividends. The question did not concern whether there *was* a distribution, but rather the amount thereof, which, in turn, depended upon whether certain gain included in "earnings and profits" was properly computed by using as the basis of the

assets in question the cost to the transferors rather than the higher market value when acquired.

The Third Circuit's citation of *Helvering* v. *Griffiths, supra,* in support of the proposition that under Section 115(b) every distribution is made out of earnings or profits to the extent thereof is likewise considered inappropriate here. Petitioner does not deny the rule as stated but points to its inapplicability in the instant case. Section 115(b) of the Code attributes a source to distributions *when distributions are made,* and when such is the case, they are deemed to be made out of earnings or profits to the extent thereof. "Section 115(b) does not, however, prescribe the criteria for determining when a distribution has taken place, as distinguished from an exchange, which is governed by Section 112", *Bass* v. *Commissioner, supra,* page 308, nor does it convert "what is not income into income." *Leland* v. *Commissioner,* 50 F. (2d) 523, 525 (C. C. A. 1st, 1931).

It is submitted that there exists a real, basic cleavage between the First and Third Circuit Courts of Appeals with respect to the possibility of having a dividend, in the economic sense, distributed to a stockholder of a corporation, or of having such a distribution which is essentially equivalent to the distribution of a dividend, where surplus, in the economic sense, has not been segregated for such purpose. See Revised Statutes of New Jersey (1937) 14:8-19.

It is further submitted that the view of the First Circuit Court is buttressed by the weight of logic and reason, and that this Court should find in accordance with that view.

POINT II.

The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 112(b)(2), 112(c)(1) and 112(e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112(b)(3), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss. The presence of loss distinguishes the instant cause from *Bazley* v. *Commissioner, supra.*

At the initial argument and upon re-argument before the Third Circuit Court as well as in his briefs, petitioner submitted that the recognition of gain or loss with respect to the exchange herein involved was precluded by the application of Section 112(b)(3), as hereinafter proved under Point III, but that if it was concluded that the recognition of such gain or loss was *not* so precluded, then, no gain or loss was to be recognized because of the operation of Sections 112(b)(2), 112(c)(1) and 112(e) of the Code.

In the instant case, common stock in a corporation was exchanged for common stock and bonds in the same corporation. Were it not for the bonds, said exchange would fall completely within Section 112(b)(2), which provides that no gain or loss shall be recognized upon the exchange of common stock solely for common stock in the same corporation. However, where other property—that is, "boot" —is given in addition to stock, Sections 112(c)(1) and 112(e) become important. This type of exchange does not require a recapitalization.

Under Section 112(c)(1), if an exchange would be within Section 112(b)(2), precluding recognition of gain or loss, except for the fact that other property is given, then the *gain* to the recipient shall be recognized, but in an amount not in excess of the fair market value of such other property. Inasmuch as Section 112(c) concerns itself exclusively with the case where the fair value of the stock and boot exceed the basis of the stock surrendered in exchange therefor, it is accordingly inapplicable to the exchange herein, *which resulted in a loss.*

It should be noted that the undisputed facts herein show that the cost basis to the petitioner of his shares exceeded the fair value of the assets received by him in exchange therefor, resulting in a loss to him in the amount of $145,857.89, thereby distinguishing the instant cause from the *Bazley* case, where a gain was involved. The Tax Court, however, made no findings of fact with respect to such loss. We fail to perceive why it did not.

Having resulted in a loss, the exchange would be governed by Section 112(c). This section provides that if an exchange would be within Section 112(b)(2) if it were not for the boot, and if the exchange results in a loss, such loss is not to be recognized, even though the transaction involves boot.

The respondent advanced an argument in the court below which emasculates Sections 112(b)(2) and 112(c)(1). He contended that the new stock received in exchange herein was essentially the same as the old stock, that the equity interest of the taxpayer in the corporation was not altered, and that the stockholders in reality surrendered nothing in respect of the stock, but merely received the bonds, the equivalent of cash, in addition to what they had before, resulting in a dividend.

But those very consequences are envisaged by the statute. Certainly, upon an exchange of common stock solely for common stock or preferred stock solely for preferred stock in the same corporation as contemplated by Section 112(b)(2), the new stock will, of necessity, be essentially the same as the old and equity interests will remain unchanged. And when an exchange would be of that type *except that* property or the equivalent of cash or cash is, in addition, received by the taxpayer, then under Section 112(c)(1), *gain*, if any, is recognized in "an amount not in excess of the sum of such money and the fair market value of such other property". On the other hand, loss, if any, in the latter situation, would not be recognized. Section 112(e).

Neither the respondent nor the Courts below questioned the reality of the exchange herein of petitioner's common stock of par value for common stock of no par value, nor has the respondent or any court ever advanced the corporate business purpose test in Section 112(b)(2) situations.

Is not the instant exchange therefore completely within the statute? If the respondent's contention is adopted, is not the effect thereof to write those sections out of our revenue law?

Petitioner submits that the answer to these questions should be in the affirmative. The instant exchange is exactly the type Congress envisaged when those provisions were enacted, if held not to come within Section 112(b)(3).

Petitioner feels it incumbent to point to the naivetè of respondent in suggesting below that the reduction in the stated value of the stock could have been evidenced just as well, so far as the record shows, by book entries and a notation on the old certificates as by a formal exchange of stock (Brief for Respondent to C. C. A. 3, p. 30). The corporation law of New Jersey provides that, in order to accomplish

the steps herein taken, there must be a formal plan of recapitalization adopted by the Board of Directors and stockholders of a corporation and that a certificate setting the same forth must be filed with the Secretary of State (Revised Statutes of New Jersey (1937) 14:11-1, 2). The method suggested by respondent would not only violate the New Jersey statutes in such cases made and provided, but would be *ultra vires* the corporation.

It is clear, therefore, that even if the Third Circuit Court is correct in its conclusion that the recognition of gain or loss is not precluded by Section 112(b)(3), which is denied, the application of Sections 112(b)(2) and 112(e) precludes the recognition of loss and compels the very result for which petitioner contends. The Court's failure to consider the problems inherent in the latter sections has greatly prejudiced petitioner's position herein, and has resulted in grave injustice to him. The inequity of having something taxed to him as *a dividend* when the transaction resulted *in a loss* is manifest.

POINT III.

The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein must have a corporate business purpose (as distinguished from a shareholder purpose) to be within Sections 112(g)(1)(E) and 112(b)(3) is interstitial legislation injecting a new requirement into the statute. Said requirement is an unwarranted extension of authority established by this Court in *Gregory* v. *Helvering, supra.*

The Circuit Court of Appeals for the Third Circuit is the first appellate tribunal, so far as can be ascertained,

to inject into Sections 112(g) (1) (E) and 112(b) (3) the requirement that a recapitalization, to be within the non-recognition provisions, must have a corporate business purpose as distinguished from a shareholder purpose. *Bazley* v. *Commissioner*, *supra*.

There appears to be no legislative or judicial precedent for such requirement. There is nothing in the plain language of the statute which requires such a purpose. There is nothing in the legislative history of the foregoing sections which indicates that the enactors thereof intended that such purpose should be prerequisite to the invocation and operation of the sections. In fact, the whole doctrine is a fiction of the Tax Court, having been brought to light in recapitalization cases for the first time in *Louis Wellhouse, Jr.*, 3 T. C. 363 (1944).

A. The exchange herein involved falls within the exact tenor of Section 112(b)(3). Where a statute is clear and unambiguous on its face, resort to extraneous materials for the purpose of interpreting it is improper.

The Code clearly provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation. Section 112(b)(3). It is submitted that each and every element required for the non-recognition of gain or loss exists herein, and that the instant case is entirely within the tenor of said section.

That the plan of the Newark Theatre Building Corporation effected a "recapitalization" within Section 112(g)(1)(E) and therefor a "reorganization" has not been questioned by the Commissioner of Internal Revenue,

the Tax Court, or the Third Circuit Court of Appeals.[1] Likewise, that debentures constitute securities,[2] and that par value common stock in the corporation was exchanged solely for no-par value common stock and such securities within the framework of the existing corporation is not open to doubt. The evidence is clear that the exchange was a unitary, integrated exchange of petitioner's shares in the corporation for shares and securities in the same corporation, and that such exchange amounted to no more than the "reshuffling of a capital structure within the framework of an existing corporation". *Helvering* v. *Southwest Consolidated Corporation*, 315 U. S. 194, 62 S. Ct. 546 (1942); *Bass* v. *Commissioner*, *supra*. Authority is equally clear that such an exchange may not be broken into one exchange plus a distribution, or into a multiple exchange.[3] What was effected as to petitioner, was "a mere reshaping of his interest in the same corporation

---

[1] On facts identical to those herein involved, the Board of Tax Appeals held this type of adjustment in capital structure to be a "recapitalization" and therefore a "reorganization". *Edgar M. Docherty*, 47 B. T. A. 462 (1942). Other decisions by the Board and courts in cases involving slight differences in fact, such as exchanges of a corporation's debentures for preferred stock, have held such to be a "recapitalization". *Annis Furs, Inc.*, 2 T. C. 1096 (1943); *Commissioner* v. *Capento Securities Corporation*, 140 F. (2d) 382 (C. C. A. 1st, 1944), aff'g 47 B. T. A. 691 (1942); *Clarence J. Schoo*, 47 B. T. A. 459 (1942), Commissioner's appeal dismissed (C. C. A. 1st, 1943).

[2] Decisions holding debentures "securities" are legion. *Edgar M. Docherty*, *supra*; *Clarence J. Schoo*, *supra*; *South Atlantic Steamship Line*, 42 B. T. A. 705 (1940); *Commissioner* v. *Neustadt's Trust*, 131 F. (2d) 528 (C. C. A. 2nd, 1942); *Commissioner* v. *Kolb*, 100 F. (2d) 920 (C. C. A. 9th, 1938). Neither Court below held otherwise.

[3] *Helvering* v. *Minnesota Tea Co.*, 89 F. (2d) 711 (C. C. A. 8th, 1937), aff'd 302 U. S. 609, 58 S. Ct. 393 (1938); *Starr* v. *Commissioner*, 82 F. (2d) 964 (C. C. A. 4th, 1936), cert. den. 298 U. S. 680, 56 S. Ct. 948 (1936); *Ahles Realty Corp.* v. *Commissioner*, 71 F. (2d) 150 (C. C. A. 2nd, 1934), cert. den. 293 U. S. 611, 55 S. Ct. 141 (1934).

through a recapitalization". *Schoo, supra,* page 461, citing *LeTulle* v. *Scofield*, 308 U. S. 415, 60 S. Ct. 313 (1940).

Each element required by the plain language of Section 112(b)(3) is here present, and for this reason it is submitted that gain or loss should not be recognized to petitioner. *Docherty, supra; Schoo, supra; Annis Furs, Inc., supra; Commissioner* v. *Capento Securities Corporation, supra; Bass* v. *Commissioner, supra; Jacob Fischer,* 46 B. T. A. 999 (1942).

Section 112(b)(3) is clear and unambiguous on its face. There is, in reality, no doubt about the meaning of any word or phrase used therein. Under such circumstances it is submitted that no judiciary body is justified in looking to extraneous source material for a construction of something about which there is no doubt, for the purpose of injecting a new requirement therein. Judge Opper, who wrote the majority opinion for the Tax Court below, recognized this in *Charles R. Brown*, 7 T. C. No. 86 (Docket No. 9146, 9/10/46), where, in construing Section 22(k) of the Code, he wrote: "The statutory command is thus so forceful and unambiguous that even were the legislative history more helpful we should not feel justified in resorting to it" (Slip Opinion, p. 2).

One might apply general principles of law in an analogous situation, to wit, where a contract is clear and unambiguous on its face, resort may not be had to extraneous writings of one of the parties to demonstrate that he did not intend the ordinary usage of the words in the contract.

It is submitted that inasmuch as Section 112(b)(3) is clear, definite and unambiguous on its face, and the instant case falls squarely within the tenor thereof, fundamental rules of statutory construction preclude the insertion therein of any additional requirement not enacted by Congress.

B. The legislative history of the reorganization sections herein involved and pertinent decisions clearly show that a corporate business purpose as distinguished from a shareholder purpose is not required.

There is nothing in the legislative history of Sections 112(b)(3) and 112(g) which implicitly or explicitly requires the presence of a corporate business purpose as distinguished from a shareholder purpose in order to qualify a reorganization for tax-free status within the terms thereof. The intent of Congress with respect to these sections was only to preclude "astute lawyers" from attempting "to take advantage of these provisions by arranging in the technical form of a reorganization, within the statutory definition, *what were really sales*". (Italics supplied.) House Ways & Means Committee, Rep. No. 704, Revenue Bill of 1934, 1939—1 C. B. (2) 554, 564. Section 112(b)(3) was introduced to permit flexibility in *bona fide, non-sham* adjustments of corporate capital structures without the imposition of tax. (See Point IV, A, *infra*, for a full discussion thereof.) Where a transaction purporting to be a reorganization is in fact a reorganization, Congress intends it to be given special treatment; but where a "taxable sale" or any other transaction not a reorganization is cast into the "form of a reorganization", preferential treatment is not to be accorded thereto.

This principle, and nothing more, was enunciated by this Court in *Gregory* v. *Helvering, supra,* the decision which allegedly establishes the necessity for a corporate business purpose as distinguished from shareholder purpose in reorganization transactions. In that case, petitioner sought to bring about a "reorganization" under

Sections 112(g) and 112(i)(1)(B) of the Revenue Act of 1928, set forth below.[4] In holding against the petitioner this Court stated at pages 469-470:

> "... It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. United States *v.* Isham, 17 Wall 496, 506, 21 L. Ed. 728; Superior Oil Co. *v.* Mississippi, 280 U. S. 390, 395, 396, 50 S. Ct. 169, 74 L. Ed. 504; Jones *v.* Helvering, 63 App. D. C. 204, 71 F. (2d) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. ...
>
> "... Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having *no business or corporate purpose*—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize

---

[4] "Sec. 112. • • • (g) Distribution of Stock on Reorganization. If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized. • • •

"(i) Definition of Reorganization. As used in this section • • •

"(1) The term 'reorganization' means • • • (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred • • • 26 USCA Sec. 2112 (g), (i)(1)."

a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. . . .

". . . The whole undertaking, though conducted according to the terms of subdivision (B) was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." (Italics supplied.)

Six months after the *Gregory* case, the Circuit Court of Appeals for the Second Circuit in *Chisholm* v. *Commissioner*, 79 F. (2d) 14 (C. C. A. 2nd, 1935), cert. denied, 296 U. S. 641 (1935), interpreted the meaning of the decision in *Gregory* v. *Helvering*. The Court, at page 15, stated:

". . . It is important to observe just what the Supreme Court held in that case. It was solicitous to reaffirm the doctrine that man's motive to avoid taxation will not establish his liability if the transaction does not do so without it. It is true that that Court has at times shown itself indisposed to assist such efforts, Mitchell *v.* Commissioner, 91 U. S. 206, and has spoken of them disparagingly, Shotwell *v.* Moore, 129 U. S. 590; but it has never, so far as we can find, made that purpose the basis of liability; and it has often said that it could not be such. *The question always is whether the transaction under scrutiny is in fact what it appears to be in form;* a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance. True, it is always the intent that controls; and we need not

for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent but not the whole, transaction would realize. *In Gregory* v. *Helvering, supra, (293 U. S. 465), the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world.*" (Italics supplied.)

The foregoing quotations indicate, without a doubt, that the basis of the holding of this Court in the *Gregory* case is that there was, in fact, no reorganization; it was all a façade. Had the reorganization not been "an elaborate and devious form of conveyance *masquerading* as a corporate reorganization" (italics supplied) and had "a reorganization in *reality*" (italics supplied) been effected, the result of the case would have been different. In fact, a different result was reached in the *Chisholm* decision where the petitioner and his brother organized a partnership, to which they transferred title to certain stock, in order to "postpone, and perhaps altogether escape, the taxes which would otherwise become due upon the sale" thereof. In holding for the petitioner, the Court said that although the partnership was formed confessedly to escape taxation, the association of individuals was in fact a bona fide partnership.

Regardless of motive or purpose, the intent of the Newark Theatre Building Corporation *was to effect a recapitalization* through an exchange of stock and debentures for outstanding stock. It did in fact implement its intent by consummating such an exchange; there was nothing illusory about it nor did it represent "artifice" as contrasted with "reality".

An analysis of cases more recently decided discloses that this Court has recognized and articulated the actual rule of *Gregory* v. *Helvering, supra,* in tax cases involving family partnerships. In *Tower* v. *Commissioner, supra,* and *Lusthaus* v. *Commissioner, supra,* this Court recognized and reaffirmed the legal right of a taxpayer to decrease his taxes by lawful means, but struck through the partnership therein involved as a mere superficial arrangement, something which did not exist in *reality,* inasmuch as there had been no change in the husband's economic interest in the business. The basis of these decisions is that there was no *real* partnership between the petitioner and his wife, it being merely "clothed in the outer garment of respectability."[5]

To the same effect in connection with a sale of property is *Commissioner* v. *Court Holding Company, supra,* where this Court struck through various sales negotiations as mere formalities designed to make the transaction appear to be other than what it was. This Court, citing the *Gregory* case, stated that a sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a *conduit* through which to pass title.

---

[5] In fact, the Tax Court applied the actual *Gregory* rule to partnership cases, prior to the decisions in the *Tower* and *Lusthaus* cases. *Walter W. Moyer,* 35 B. T. A. 1155 (1937); *J. D. Johnston, Jr.,* 3 T. C. 799 (1944); *Robert P. Scherer,* 3 T. C. 776 (1944); *Felix Zukaitis,* 3 T. C. 814 (1944); *M. W. Smith, Jr.,* 3 T. C. 894 (1944).

Decisions with respect to transactions involving corporate recapitalizations, except recent ones of the tax Court, have been in the same vein. Holdings by this Court and the Federal courts bear out petitioner's contention that the *Gregory* case does not require that a reorganization, in order to be effective tax-wise, must have a corporate business purpose as distinguished from a shareholder purpose.[6] In fact, it is submitted that this Court's decision in *John Kelley Company* v. *Commissioner, supra,* completely undermines the respondent's position in that respect.

In the *Kelley* case, the taxpayer-corporation had an authorized capitalization, on January 1, 1937, of 1,500 shares of no par common stock and 3,000 shares of 6% cumulative preferred stock of $100.00 par value, of which 1,110 of the common and 1,124 of the preferred were outstanding. All of the stock was owned directly or indirectly by members of a family group. On January 11, 1937, the corporation adopted a plan of recapitalization pursuant to which the common stock was changed to $100.00 par value and increased to 6,000 shares. In addition, twenty-year "income debenture bonds," aggregating $250,000.00 and bearing annual interest of 8%, were authorized. Payment of interest was conditioned upon the sufficiency of the net income of the taxpayer to meet the obligation. Debentures were issued in the amount of $150,000.00 face value, the greater part thereof, or $114,648.00, being exchanged for the original preferred stock, and the balance thereof being

---

[6] *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, 56 S. Ct. 269 (1935); *Griffiths* v. *Commissioner*, 308 U. S. 355, 60 S. Ct. 277 (1939); *National Investors Corp.* v. *Hoey*, 144 F. (2d) 466 (C. C. A. 2nd, 1944); *Electrical Securities Corp.* v. *Commissioner*, 92 F. (2d) 593 (C. C. A. 2nd, 1937); *Commissioner* v. *Gilmore's Estate*, 130 F. (2d) 791 (C. C. A. 3rd, 1942).

sold to the common stockholders. Common stock was owned in the same proportions by the same stockholders before and after the reorganization.

The Commissioner determined deficiencies in tax for the calendar years 1937, 1938, and 1939, by virtue of a disallowance of taxpayer's deduction of payments made in each of said years on the debentures as interest on indebtedness.

The Commissioner contended that the payments were dividends under Section 115(a) of the Revenue Act of 1936 and not interest within the meaning of Section 23(b).

In holding for the taxpayer and against the Commissioner, this Court stated that there was not present in the *Kelley* "situation the wholly *useless temporary* compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering*, 293 U. S. 465" (Italics supplied). This Court then went on to consider the characteristics of the obligations in question, and to determine that the indicia thereof supported the conclusion that they were an indebtedness.

It is submitted that said decision is of momentous importance with respect to the instant cause because of their parallelism and should, accordingly, guide this Court in its determination herein.

It is to be noted that the Commissioner in the *Kelley* case urged the *Gregory* decision upon this Court in support of the underlying theory that no effect was to be given to the reorganization involved therein, and that, consequently, what purported to be bonds were not bonds nor were the sums distributed interest on such bonds, but dividends on stock. This Court interpreted the *Gregory* decision adversely to the Commissioner, and favorably to the taxpayer, stating that *useless* and *temporary* compliance

with the statute characterizes a *Gregory* situation. In other words, this Court's decision is predicated on the notions that a reorganization was in fact consummated, that pursuant thereto, bonds were issued in exchange for preferred stock, that there was nothing useless about the reorganization and that it was characterized by some degree of permanency. With these fundamental assumptions in mind, this Court then proceeded to consider whether the ingredients of the obligations were such as to permit of the deductibility of payments thereon as interest.

The Commissioner's approach in the case at bar is similar. He is, in reliance on the *Gregory* decision, urging that no effect be given to the reorganization. Certainly, a plan of reorganization was adopted herein and consummated according to the terms thereof. Genuine stock and bonds were issued in exchange for the old stock. There was, indeed, no useless compliance with the statute, such compliance resulting in the savings of thousands of dollars in income and franchise taxes, as hereinafter set forth in Part C hereof. Nor can it be said that compliance was temporary, inasmuch as the bonds herein were issued and are still outstanding.

Even the Tax Court, prior to the creation of its fiction, held the same way in recapitalization cases. In the *Schoo* case, *supra*, the Board of Tax Appeals stated at page 462:

> "There is nothing in the circumstances to invite the doctrine of *Gregory* v. *Helvering*, 293 U. S. 465. . . . The recapitalization is not a sham or an artificial detour around a taxable event. There is nothing to indicate that a devious form of corporate maneuvering was masquerading as a recapitalization in order to avoid a tax which would have been assessed if the transaction had been permitted to take its direct course."

This was said by the Board *even though the purposes of the reorganization, as stated by the president of the corporation to its shareholders, included a reduction in transfer taxes, as well as in income tax by the issuance of bonds.* Similarly the Board in the *Docherty* case, *supra*, stated at page 464:

> "There is nothing to arouse the application of the doctrine of *Gregory* v. *Helvering*, 293 U. S. 465, for the recapitalization was a bona fide readjustment of the corporation's financial structure for a legitimate business purpose. The evidence to that effect is entirely credible and there is neither fact nor circumstance to throw it in doubt."

From the foregoing decisions, it is clear that *the end* that is sought to be accomplished by the taxpayer is the important thing, regardless of the *motive* therefor. Judicial concern is whether a reorganization, or a partnership, or a sale or the issuance of a bond, as the case may be, has in actuality been effected. Once this actuality has been effected, the motive therefor, "whether to avoid taxes, or to regenerate the world," is immaterial.

The whole question has been excellently stated and discussed by Judges Maris and Goodrich in their dissenting opinion in *Bazley* v. *Commissioner*, *supra*, adopted by them with respect to the instant case. It is in great measure now quoted:

> "The . . . question is whether a corporate reorganization, in order to be tax free, must be one conducted for a 'corporate business purpose' of the corporation as distinguished from serving a proper business interest of the shareholders. . . .
>
> "We think that the criterion here making a distinction between 'corporate' and 'shareholder' purpose is incorrect. The foundation for it is supposed to be Gregory *v.* Helvering, 293 U. S. 465 (1935). That

case involved the formation of a dummy corporation which did no business otherwise than to participate in a transfer which the taxpayer was seeking to effect without tax liability. What we had was a sale masquerading as a reorganization. The court struck through the sham.

"To expand that decision into a rule of law such as is now contended for is to push it beyond anything which we think the court could have had in mind. Nor do we think the expansion is one which a reasonable growth beyond Gregory *v.* Helvering would call for. We have long since passed the place in our thinking where we view the corporation as 'an artificial being, invisible, intangible and existing only in contemplation of law'. We think of it as a device that shareholders use to carry on their business as a group. A corporation does not have purposes apart from its shareholders. Shareholders, of course, may have conflicting interests among themselves with regard to the conduct of their common enterprise. They may fight with each other, perhaps, in order to elect A instead of B to the directorship of their company. And, of course, aside from their interest in the common enterprise, called their corporation, they have interests as varied as the hopes and desires of human beings. But when we talk about the interest of shareholders in connection with the business enterprise and have a finding of fact that such and such a thing was done and that it was to the shareholders' business advantage, speaking of them as a group, we do not find substance in a distinction between the business advantages of the shareholders with respect to the corporation or the business advantages of the corporation itself.

"Furthermore, this very thing concerned with here, reorganization, is a matter in which shareholders directly participate. The day to day busi-

ness of the corporation is done by its officers, directors, employees. But a realignment of the interests in the enterprise through reorganization must come, under every corporation law we know of, through vote of the shareholders. In such circumstances it is as a practical matter impossible to separate as to the very transaction involved a 'shareholder's' from a 'corporate' interest.

"We think the distinction attempted coming, as it does, quite a number of years after Gregory *v.* Helvering, is one not established by that decision, the statute, nor the regulations. If reorganization provisions contain too many avenues of escape for taxes which ought to be collected the Congress can close those avenues by appropriate legislation which can be so framed and defined as to leave the way clear to what it deems are business transactions in which no gain or loss should be recognized. We do not think it should be by judicial decision which establishes the exceedingly vague criterion as to whether a given transaction was to the interest of the shareholder as distinguished from the interest of the corporation in which he holds shares of stock.

"The gloss here sought to be placed upon those provisions of Section 112 of the Internal Revenue Code which render nontaxable the exchange of certain securities in connection with corporate reorganizations; can only be justified upon the assumption that all reorganizations which are put through by stockholders solely to promote their own business purposes must necessarily involve the motive of tax avoidance. Only upon this assumption can the principle of Gregory *v.* Helvering be applicable. But this assumption is quite unsound as the facts of the case before us demonstrate. And even clearer cases can readily be brought to mind. Suppose a case in which the common shareholders arrange for the reclassification of a part of their holdings as non-vot-

ing stock in order that they may sell it or give it away without endangering their voting control. This would be a perfectly proper business purpose of the stockholders involving not a trace of tax avoidance, but it would not benefit the business of the corporation as such. We do not think that there is any authority for the proposition that such a recapitalization would not be within both the letter and the spirit of Section 112."

Petitioner submits that certain overall conclusions are inescapable. There is nothing in the plain language of the statute which requires a corporate business purpose. There is nothing in the legislative history of the reorganization provisions (as outlined hereinabove and in Point IV, A, *infra*, regarding Section 112(b)(3)) which indicates that the enactors thereof intended that such purpose should be a prerequisite to the invocation and operation of the sections. This Court's decision in *Gregory* v. *Helvering*, while outlawing sham transactions, does not establish the necessity for a corporate business purpose as distinguished from shareholder purpose in non-sham reorganization transactions, and this Court, the Federal courts, and the Board of Tax Appeals in other cases have not read the requirement therefor into that decision. Even the Tax Court has conformed to this extent in its treatment of partnership cases.

It is submitted that the corporate business purpose doctrine, as applied to reorganization transactions (and particularly to recapitalizations), is a fiction of the Tax Court. It is further submitted that should the doctrine be allowed to continue in its present form, rules of law will be supplanted by rules of men. The Tax Court will virtually go into business, and substitute its subjective judgment, based on hindsight, for objective rules of law, in the determination of what is or is not a corporate business purpose.

The doctrine should be relegated to the limbo before it is allowed to do further harm to the business world that needs must follow from the uncertainty which it creates.

C. The instant plan of reorganization was adopted and effectuated for legitimate business purposes, including corporate and shareholder purposes. The Tax Court found such purposes to be present herein.

At the outset, petitioner desires it to be noted that he is not asking this Court to make separate or different findings of fact as to the purposes for the plan of recapitalization. Petitioner bases his contention herein upon those very purposes found and considered as facts by the Tax Court. *Dobson* v. *Commissioner, supra.* Even if this Court should conclude that the presence of a corporate purpose as distinguished from a shareholder purpose is necessary to give effect to a reorganization within the terms of the statute, petitioner submits that corporate business purposes are herein present and that the Tax Court found same as facts.

The uncontradicted testimony herein as well as the findings of fact by the Tax Court in both the earlier and superseding opinions are to the effect that the purposes of the plan of recapitalization included the saving of New Jersey franchise taxes in excess of $400.00 per year as well as the reduction of the Corporation's federal income tax liability by the deduction of interest paid on the bonds (R. 86a, 97a). It is submitted that these purposes are sufficient to bring the Corporation within the sanctuary of a tax-free "reorganization", and that the Tax Court was in error, as a matter of law, in holding otherwise.

As Judges Goodrich and Maris pointed out, a corporation is today not considered a being which is invisible, intangible and existing only in law. It is a device which share-

holders use to carry on a business as a group. It is axiomatic in our present day economy that the primary purposes of all commercial corporations are the realization of profit and the distribution of such profit to the investors who have contributed their capital to the corporation. It is recognized that increased profits are realized by any reduction of expense, that a reduction of expense is accomplished by a diminution in tax burden, and that a diminution in corporate tax burden may constitute a legitimate business purpose of a reorganization. *Clarence J. Schoo, supra.* See also *C. A. Munroe,* 39 B. T. A. 685 (1939); *Tower* v. *Commissioner, supra;* and holdings by the Third Circuit Court in *Meurer Steel Barrel Co.* v. *Commissioner,* 144 F. (2d) 282 (C. C. A. 3rd, 1944); *Commissioner* v. *Day & Zimmerman,* 151 F. (2d) 517 (C. C. A. 3rd, 1945). So also does a reduction in the corporation's liability for dividends or interest constitute a legitimate business purpose. *Annis Furs, Inc., supra.* Furthermore, Judge Kern of the Tax Court has recognized, and, it is submitted, rightfully so, that even where, as here, the reduction in a corporation's tax liability gives rise to an increase in liability for interest on the bonds in an equal or greater amount, a legitimate corporate business purpose is present where the investors of the corporation receive a greater distribution of money in the form of dividends and interest than they received as dividends prior to the recapitalization.

The Tax Court, however, has seen fit to introduce a further refinement into the statute, without any warrant therefor, by stating that a corporate business purpose must be of benefit to the corporation. The Tax Court has thus extended the doctrine of the corporate business purpose, in itself a fiction, to the point where something which is a purpose is not treated as a purpose unless it is of benefit

to the corporation. The Tax Court accordingly rejected the savings of income tax by the corporation as a corporate business reason, by virtue of the alleged disadvantage to the corporation in undertaking an annual obligation to pay interest on a sum of money in order to obtain a tax reduction in a smaller amount.

The correctness of the Tax Court's theory that where the reduction in the corporation's income tax liability is accomplished by an increase in liability for interest in an equal or greater amount, the reduction in tax liability cannot be said to be a corporate business purpose, is questioned for two reasons.

In the first place, if this argument were carried through to its logical and inevitable conclusion, the issuance of bonds for stock in a recapitalization could *never* be a corporate business purpose of benefit to the corporation because the recapitalization will always result in the creation of a liability where none existed previously. Even the Tax Court has recognized this. In *Annis Furs, Inc., supra,* shares of 6½% cumulative preferred stock were exchanged in a recapitalization for 6% debenture bonds. Said the Tax Court: "It cannot be said * * * that this recapitalization served no reasonable or legitimate business purpose, for the reduction of the corporation's periodic charge from 6½%, as the dividend was under the preferred shares, to 6% as the interest became under the debentures, was a sufficient financial advantage to explain and justify the change." (p. 1098). Thus, the Tax Court found business purpose even though, pursuant to the recapitalization, a liability in the form of bonds outstanding was created, whereas prior to the recapitalization there was no such liability. The existence of cumulative preferred stock merely defines the rights, privileges and preferences as

between proprietary interests; there exists no corporate obligation until dividends are declared. The issuance of bonds, however, creates a definite obligation and liability to creditors, from the moment of issuance. It is submitted that if the Tax Court is followed in this respect, Section 112 (b)(3) will be emasculated.

In the second place, the proposition of the Tax Court overlooks a fundamental principle of economics and finance, to wit, that under certain circumstances, it may be a business purpose of benefit to the corporation to borrow money from outsiders for the conduct of its business even where the amount of tax saved is less than the liability created for interest commitments. This may be illustrated by an example. Suppose that A and B organize a corporation to operate a business which will require an investment of $100,000.00, and that the risk of this type of business requires a 20% return on capital. Assume that they are offered a $50,000.00 loan by outsiders, but desiring a closed corporation, they invest the $100,000.00 from their own funds. Their yearly return on their investment will be $20,000.00. Suppose, however, that the corporation originally takes advantage of the $50,000.00 loan offered, and issues common stock to A and B in the amount of $50,000 and 6% bonds to outsiders in the amount of $50,000. The corporation now has outstanding bonds payable in the amount of $50,000.00 and capital stock of $50,000.00. The corporation's net profit for the year, after the deduction for interest on the bonds in the amount of $3,000.00 (6% of $50,000.00), is $17,000.00. Although the latter amount is less in total figure, such yield is on the basis of an investment of $50,000.00. Whereas, prior to the recapitalization the yield upon the common stock was 20% ($20,000.00 return on $100,000.00), the yield subsequent thereto has in-

creased to 34% ($17,000 return on $50,000.00). It is apparent that such an increased yield per share inures to the benefit of the investor as well as to the corporation. The investor receives a greater return on his investment; the corporation now has outstanding stock of far greater salability. It is submitted that the majority opinion of the Tax Court did not take cognizance of the foregoing expedient of trading on the equity or implementing financial leverage—using other people's money—in the consideration of this phase of the instant cause. Had the majority considered this principle, they could not have stated that if "the money were to be borrowed from strangers, it seems evident that this could not but be a losing transaction for the corporation." (R. 103a).

But even if there is some basis for the Tax Court's holding in that respect, which is denied, *the Court did not answer petitioner's argument that the Corporation also effected a saving in state franchise taxes. It cannot be gainsaid that such savings constituted a corporate business purpose, and that such purpose was of benefit to the Corporation.* Notwithstanding any statement to the contrary by respondent, the Tax Court did not reject this purpose as being of no benefit to the Corporation. The Court in fact neglected to do more than mention the franchise tax issue in its opinion (R. 103a), without disposing of it. Petitioner reiterates that the saving to the Corporation has already exceeded $2,000 since the date of the reorganization and will continue at the rate of $413.98 each and every year during its existence. This purpose, in and of itself, suffices as a corporate business purpose, however such phrase may be defined.

The last purpose for the recapitalization found and considered as a fact by the Tax Court in the instant cause

was that petitioner wished to give bonds of the Corporation to his two sons, who were associated with him in the business, without surrendering any of his stock control over the company (R. 98a, 102a-103a). Although the Tax Court dismissed this reason as a personal one, having no connection with the corporate business, this purpose is equally consistent with the petitioner's desire to preserve continuity of control for the benefit of the corporation's business by giving away a non-proprietary interest therein.

Petitioner submits that the foregoing purposes are sufficient to bring the recapitalization herein within the provisions of Section 112(b)(3), whether or not a corporate business purpose as distinguished from a shareholder purpose is required. Petitioner submits, further, that even if corporate business purpose of benefit to the corporation is required, there is at least one such purpose herein which meets all the refinements presently injected into the statute, and that the recapitalization should be given effect on that basis.

POINT IV.

There is no basis for the holding of the Third Circuit Court, affirming the decision of the Tax Court, that the reorganization herein gave rise to a distribution essentially equivalent to the distribution of a taxable dividend under Section 115(g) of the Internal Revenue Code.

The majority opinion of the Tax Court, affirmed by a majority of the Third Circuit Court, is based on the premise that the reorganization herein amounted to a distribution and that "the distribution was a dividend or its essential equivalent," as envisaged by Section 115(g) of the Code.

It is submitted that there is no basis whatsoever for such a conclusion. Moreover, there was no distribution of a dividend within Section 115(a).

A. The legislative history of Sections 112(b)(3) and 115(g) furnishes proof that the instant transaction is not governed by Section 115(g).

Although the present terminology of Section 112 (b)(3) first appeared in Section 203(b)(2) of the Revenue Act of 1924, its roots can be found in the Revenue Acts of 1918 and 1921.[7]

Congressional intent and purpose with respect to the reorganization provisions are best gleaned from an examination of the contemporaneous reports of the committees considering them. Thus, Section 202(b) of the Act of 1918 was "designed to establish the rule for determining taxable gains in the case of exchanges of property and to negative the assertion of tax in the case of certain purely paper transactions". Senate Finance Committee, Rep. No. 617, Revenue Bill of 1918, 1939—1 C. B. (2) 117, 120. The Committee pointed out that when in connection with the reorganization of a corporation, a person receives in place of

---

[7] Section 202 of the Act of 1918 contained provisions pertaining to the recognition of gain or loss, subsection (b) thereof providing that "when property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged".

Section 202(c)(2) of the Act of 1921 provided that no gain or loss shall be recognized when, "in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization."

stock or securities owned by him new stock or securities of no greater aggregate par value, no gain or loss shall be deemed to occur from the exchange. Senate Rep. No. 617, *supra*.

New and explicit rules for the determination of gain or loss upon exchange transactions were introduced into the Revenue Act of 1921 to eliminate "many technical constructions which are economically unsound" and to "permit business to go forward with the readjustments required by existing conditions". Senate Finance Committee, Rep. No. 275, Revenue Bill of 1921, 1939—1 C. B. (2) 181, 189; House Ways & Means Committee, Rep. No. 350, Revenue Act of 1921, 1939—1 C. B. (2) 168, 176. Both Congressional committees recognized that the law as it then existed made a presumption in favor of taxation and that the Act under consideration modified that presumption in exchange transactions. Section 202(c) provided "new rules for those exchanges or 'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit". Senate Rep. No. 275, *supra*, at 188. The policy adopted by Congress of exempting from tax the gain from exchanges made in connection with a reorganization in order that ordinary business transactions would not be prevented was similarly recognized in discussions regarding the Revenue Act of 1924. House Ways & Means Committee, Rep. No. 179, Revenue Bill of 1924, 1939—1 C. B. (2) 241, 251; Senate Finance Committee Rep. No. 398, Revenue Bill of 1924, 1939—1 C. B. (2) 266, 276.

With the foregoing as a background, the full import of the words of Judge Arundell of the Tax Court in his dissenting opinion are more readily comprehensible and appreciable. Indeed, the "so-called corporate reorganization provisions of the revenue acts were designed to permit some

flexibility in the financial set-up of corporations without the present imposition of a tax due to such changes. It was recognized that our capitalistic economy could not properly function if it was kept in a strait-jacket, as it most surely would be if a tax consequence resulted with every change in the financial structure. Thus, recapitalizations were permitted without the present recognition of tax, leaving the imposition of the tax to the time when the exchanged security should be finally disposed of. No one contends that if the recapitalization is, in fact, a fraud or sham it is to be recognized . . ." (R. 110a).

It is clear, therefore, that the genesis and growth of the reorganization provisions of our revenue law are such as to make the transaction under consideration entirely within the compass thereof.

On the other hand, a parallel investigation of the legislative history of Section 115(g) proves as conclusively that it is not applicable to transactions such as the instant one.

The reason for the introduction into our revenue laws of Section 115(g) and its antecedent provisions can be traced back to the decision of the Supreme Court in *Eisner v. Macomber, supra*, in which it was held that a dividend of common stock upon common stock did not give rise to taxable income. The effect of Section 201(d) of the Revenue Act of 1921 and Section 201(f) of the Revenue Act of 1924 was that, although a stock dividend was stated not to be subject to tax, a taxable dividend was said to exist if *before or after the distribution of any such dividend*, the corporation redeemed its stock at such time and in such manner as to make the distribution essentially equivalent to the distribution of a taxable dividend. Congress intended to provide for the case in which a corporation first redeems a portion of its stock and then declares a stock dividend as

well as the case in which the corporation first declares the stock dividend and then redeems a portion of its stock. (See Senate Finance Committee, Report No. 275, Revenue Bill of 1921, 1939-1 C. B. (2) 181, 187; Ways and Means Committee, Report No. 179, Revenue Bill of 1924, 1939-1 C. B. (2) 241, 250; Senate Finance Committee, Report No. 398, Revenue Bill of 1924, 1939-1 C. B. (2) 266, 275).

It can thus be seen that the genesis of the presently designated Section 115(g) of the Code is steeped and inextricably enmeshed in considerations emanating from the stock dividend consciousness of Congress, and that the sections of prior revenue acts corresponding thereto "were enacted by Congress in an attempt to prevent the avoidance of tax upon distributions of corporate earnings, ordinarily to be distributed as dividends and so taxable, by means of redemption and cancellation of stock." *Annie Watts Hill*, 27 B. T. A. 73, 75 (1932), aff'd. 66 F. (2d) 45 (C. C. A. 4th, 1933); *Leopold Adler*, 30 B. T. A. 897, 905 (1934), aff'd 77 F. (2d) 733 (C. C. A. 5th, 1935).

Congress subsequently recognized the potentialities of partial liquidations for tax evasion purposes, and attempted to control the incidents thereof. This it did by writing into the Revenue Act of 1926 an all-inclusive provision giving the Commissioner plenary power to protect the revenues against tax evasion practices consisting of the redemption of stock "whether or not such stock was issued as a stock dividend." (Section 201(g) of the Revenue Act of 1926).

Nowhere does it appear that Congress intended Section 115(g) to apply to recapitalizations or to situations where a corporation's own bonds were issued in connection therewith.

B. The law and the applicable regulations demonstrate that the instant transaction cannot be governed by Section 115(a).

Section 115(a) provides in general terms that a "dividend" is any distribution by a corporation to its shareholders. The word "distribution" is not defined in the statute. Reference to the regulations indicates that the term "dividend" comprises any distribution *in the ordinary course of business.* Regulations 103, Section 19.115-1.

It is evident that the instant transaction does not fall within Section 115(a). In the first place, there was here an *exchange,* not a distribution, however the latter may be defined. That there is a distinction between the terms "distribution" and "exchange", and that the former does not include the latter, is evidenced by Section 115(c) which provides that in certain instances (notably, liquidations), a *distribution* is to be treated as payment in *exchange* for the stock. But for that specific provision, there would be no affinity between those concepts. In the second place, even if there existed a "distribution" in the instant cause, which is denied, there was no such distribution as to constitute a "dividend" inasmuch as what was herein effected was not done in the ordinary course of business.

In view of the foregoing, it is submitted that the common acceptation of the meaning of "distribution" must be attributed thereto. Its derivation from the Latin prefix "dis" meaning "apart" and the verb "tribuo" meaning "give" indicates the true definition thereof. The term connotes the *segregation* of corporate earnings and their *transfer* to stockholders. *Eisner* v. *Macomber, supra.*

In the instant cause, there was no segregation of earnings and there was no transfer or distribution thereof.

On past occasions, the Tax Court has indicated the necessity of a declaration as requisite to the presence of a divi-

dend. *Wellhouse, supra.* The facts herein certainly show the absence of any such declaration.

Petitioner submits that the foregoing illustrates the inapplicability of Section 115(a) to the instant exchange.

C. Judicial precedents with respect to Sections 112(b)(3) and 115(g) illustrate the inapplicability of Section 115(g) to the instant transaction.

The malapropoism of Section 115(g) herein is evidenced by recapitalization cases as well as typical 115(g) cases.

In *Louis Wellhouse, Jr., supra,* the petitioners exchanged 400 shares of common stock, which were then cancelled, for 400 shares of preferred stock in the same corporation, and subsequently paid off their personal debts. No change was made in surplus. Although the Tax Court held that there was no reorganization with corporate business purpose sufficient to cause nonrecognition of gain or loss under Sections 112(b)(3) and (g)(1) of the Code, it specifically denied the applicability of Section 115(g) with respect to the new preferred stock. The Court based its holding on the fact that there was no distribution out of earnings or profits, and that the surplus account remained unchanged in amount. The Court said that "section 115(g) is limited to a distribution out of earnings and surplus" (p. 370). As has been previously pointed out, there was no change in the earnings and profits, or surplus, account of the Newark Theatre Building Corporation.

In rejecting the applicability of Section 115(g) to the reorganization involved in the *Wellhouse* case, the Tax Court relied upon *H. Y. McCord,* 31 B. T. A. 342 (1934). There, the corporation involved reorganized its capital structure by exchanging 4,000 shares of common stock outstanding for 500 shares of common and 750 shares of preferred stock. In holding the recapitalization to be within

the statutory definition of a reorganization, the Board of Tax Appeals stated that no "question arises under Section 115(g) because, as we have seen, *the cancellation of outstanding shares was not for cash, but only in exchange* for new common and preferred shares" (p. 343) (italics supplied).

The same result was reached by the Tax Court in *Annis Furs, Inc., supra,* where shareholders surrendered their 6½% preferred stock in exchange for the corporation's 6% debentures. The Court determined that the exchange was a statutory reorganization upon which gain was not recognized, pursuant to Section 112(b)(3) of the Code, and that the exchange did not result in a distribution essentially equivalent to the distribution of a dividend under Section 115(g).

Other cases involving a recapitalization which rejected the Commissioner's attempt to foist a Section 115(g) argument upon the Court are *South Atlantic Steamship Line, supra; Skenandoa Rayon Corporation,* 42 B. T. A. 1287 (1940), aff'd. 122 F. (2d) 268 (C. C. A. 2nd, 1941); and *Jacob Fischer, supra.*

Approaching the problem from the 115(g) viewpoint, we find that the characteristic ingredients which generally have been held by courts to constitute redemptions and cancellations as being essentially equivalent to the distribution of dividends are totally lacking in the instant case. The well-known Section 115(g) criteria of taxability are absent, as are the time and manner of the cancellations pointing to essential equivalence.[8] Nor have taxable consequences been found in Section 115(g) decisions as the result of distribu-

[8] For a comprehensive treatment of the section and cases thereunder, see Sydney A. Gutkin and David Beck, "Stock Redemptions As Taxable Events Under Section 115(g): The Impressionistic Test", *Journal of Accountancy,* October 1945.

tions of the stock or bonds of the issuing company in, or with respect to, reorganizations.

What the Tax Court is here attempting is to take a Section 112 transaction out of the compass of that section and to force it into the mold of Section 115. This is in direct violation of the language of the Supreme Court. *Commissioner* v. *Estate of Bedford, supra.*

D: Section 115(g) is essentially a liquidation provision, thereby being inapplicable herein.

The terminology of Section 115(g) indicates that the situations envisaged thereby are those involving the cancellation or redemption of stock. In other words, the section is invoked where there is a partial liquidation of a corporation by the elimination of part of its total outstanding capital stock through redemption or cancellation.

In the instant case, however, there was no such "liquidation." Although technically, of course, there was a cancellation of the old shares upon their surrender, in reality, there was an *exchange* of an equal number of old shares for new shares. There was no redemption or cancellation of part of an outstanding issue in the sense that a balance of that outstanding issue remained, nor was there a complete cancellation or redemption of a portion of its outstanding stock.

It is accordingly submitted that Section 115(g) is not applicable herein.

E. The application of Section 115(g) to the instant transaction distorts the facts herein as well as the intention of the parties.

The facts in the instant case are clear that the Corporation intended to reorganize, and did reorganize by having the stockholders thereof exchange their par value common

shares for a like number of no par shares and debenture bonds. Judge Kern, who presided at the hearing of the instant cause and who was, accordingly, in a position to observe the demeanor of the petitioner and witnesses and to form a first-hand opinion, found that as a fact. Neither the majority of the Tax Court, nor the judges dissenting, found the recapitalization to be a fraud or a sham. A permanent change in the capital structure was intended and effected by the reorganization, which is the way the Corporation could have been initially organized, without criticism and without tax consequences. Judge Arundell aptly characterized the situation by stating that "*it was never intended that the tax collector or, indeed, a member of this court should pass on the wisdom or desirability of a corporate recapitalization. If what was done here was genuine and was not a sham, the test of the statute has been met.*"

It is submitted that the majority of the Tax Court was not justified in finding that no reorganization within the statutory definition was here accomplished when all the facts and the intent of the parties indicate otherwise. As previously indicated, there was no intent to declare a dividend, none was in fact declared, there was no change in the surplus account, and as much remained available for future distribution, in the accounting and economic sense, subsequent to the exchange as prior thereto.

POINT V.

The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 111, 112(a) and 117 of the Internal Revenue Code. Under these sections, even if the exchange was one upon which gain or loss was recognized, the petitioner sustained a loss as a result thereof. Accordingly, petitioner overpaid his tax for the year 1941.

At the initial argument and upon re-argument before the Third Circuit Court, as well as in his briefs, petitioner submitted that the exchange of the Corporation's par value stock for new stock and debentures, of necessity, had to fall within one of three spheres: either it is (1) a tax-free reorganization within Sections 112(b)(3) and 112(g)(1)(E), upon which gain or loss is not recognized; or (2) it is a boot transaction upon which there is loss, said loss not being recognized, pursuant to Sections 112(b)(2) and 112(c), as contended under Point II; or (3) it is an exchange upon which gain or loss is recognized, subject to treatment as a capital gain or loss, pursuant to Sections 111, 112(a) and 117 of the Code.

Petitioner argued before the Circuit Court, and now reiterates, that if it is found that the exchange herein constituted an exchange requiring the computation of the realized gain or loss under Section 111, then the extent to which such "realized" gain or loss is to be "recognized" is determined by Section 112 and the extent to which such "recognized" gain or loss is to be taxed is determined by Section 117.

If, therefore, the recapitalization herein falls within the third category enumerated above, petitioner submits that he sustained a loss therefrom in the amount of $145,857.59, which is deductible as a long-term capital loss. Accordingly, petitioner overpaid his tax in 1941 by approximately $20,000.00.

It is not deemed necessary to repeat at length what appears in the Record and with respect to which the Tax Court made no findings of fact. With respect to the cost basis of petitioner's stock, this has been shown to be $417,944.28. The total fair value of the properties received by petitioner upon the exchange herein, appraised from a reproduction and replacement standpoint, was in the amount of $469,837.00. The total fair value of said properties appraised on the basis of capitalization of gross rental, was in the amount of $515,284.00. The petitioner has deemed it fair to average the valuations for the properties by dividing the total thereof, $985,121.00, by two, thereby deriving the quotient of $492,560.00. This last figure represents the fair value of the two parcels of real estate as of the time of the recapitalization.

The other assets of the Corporation, as per its Balance Sheet as at December 31, 1940, were in the amount of $84,923.49. The total assets were therefore in the amount of $577,483.49.

From said total assets are to be deducted mortgages payable on said parcels of realty in the amount of $291,250.00, in addition to other liabilities in the amount of $14,146.80 or a total of $305,396.80.

The difference between the total assets and total liabilities represents the net value of the Corporation's assets on recapitalization. This figure is $272,086.69.

Since the cost basis of petitioner's stock has been established at $417,944.28, and the fair value of the property

received in exchange therefor has been shown to be $272,086.69, the loss to petitioner is the differential, or $145,857.59.

The equity, accuracy and inevitability of this result can be more fully appreciated after reference to Section 115(c) of the Code, which expressly provides that the complete liquidation of a corporation shall be regarded, as to stockholders, as an *exchange* of their stock for the assets of the corporation, and that gain or loss represented by the difference between the value of the assets received and the basis of their stock upon such exchange is to be determined under Section 111, recognized only to the extent provided in Section 112, and taxed at the capital gain rates provided by Section 117.

Petitioner, as the dominant stockholder, could have liquidated the company, thereby securing all its assets, and could have sustained and deducted a loss (and escaped all tax) on the transaction by exchanging assets of a greater cost than the value attributable to the assets received. He could then have conveyed the assets to a new corporation in exchange for precisely the stock and debentures which he received in the instant recapitalization, and would then have held stock and bonds on the basis of their combined value. He would have been liable for no further tax on their sale at such value or their redemption.

As it is, the petitioner has done no more than to postpone the recognition of a loss until the actual sale or exchange of the bonds.

However, should this Court find that the exchange is one upon which gain or loss is recognized, petitioner accordingly submits that the instant cause should be remanded to the Tax Court for further findings with respect to the loss in the amount of $145,857.59, and for a determination regarding petitioner's overpayment of tax.

POINT VI.

The holding of the Circuit Court of Appeals for the Third Circuit, affirming the decision of the Tax Court, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court.

The Sixteenth Amendment to the Constitution of the United States invests Congress with the power to lay and collect taxes on "incomes", from whatever source derived, without apportionment among the several States and without regard to any census or enumeration. Section 22 of the Internal Revenue Code, and the applicable regulations, define income to include all *gains* derived from capital, from labor, or from a combination of both. Both the Constitution and the statute require that there must be a realization of income before tax incidents with respect thereto may ensue.

There have been suggestions in some cases that bonds issued in connection with a recapitalization, allegedly without business purpose, are not to be treated as bonds but are to be treated in the same manner as the stock given up in exchange therefor. *Commissioner* v. *Kelley Co.*, 146 F. (2d) 466 (C. C. A. 7th, 1944), rev'd. on another ground, 66 S. Ct. 299 (1946). If this is so, there can be no realization of income herein in either the statutory or constitutional sense if the Commissioner's contention is correct that no corporate business purpose was served by the recapitalization in question.

If what was issued by the Corporation was stock and not bonds, then nothing more was accomplished than a proliferation of capital, sans taxable consequences. *Eisner* v. *Macomber, supra; Strassburger* v. *Commissioner, supra; Helvering* v. *Griffiths, supra.*

Accordingly, the bonds do not constitute taxable income and the Third Circuit Court's holding to the contrary is in error.

Furthermore, inasmuch as income has been defined as a *gain* from capital or labor, the presence of loss obviates any income. This Court has recognized that "no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as matter of fact" there was no economic gain. *Dobson* v. *Commissioner, supra,* 249.

Consequently, it is submitted that since there was a loss in fact incurred upon the transaction, it would be unconstitutional as well as unconscionable to tax petitioner on such loss.

Conclusion.

For the reasons stated in this brief, it is respectfully submitted that this Court should determine that there is no deficiency in federal income tax of this petitioner for the calendar year 1941; or, in the alternative, that petitioner overpaid his said tax in an amount to be recomputed upon a remand of this cause to the Tax Court, pursuant to a finding that he sustained a loss in that year of $145,857.89, which was not taken as a deduction in his return of income.

It is respectfully submitted that the decision of the Circuit Court of Appeals for the Third Circuit should be reversed and decision entered for the petitioner.

SYDNEY A. GUTKIN,
Attorney for and of Counsel
with Petitioner,
744 Broad Street,
Newark 2, N. J.

DAVID BECK,
On the Brief.

Appendix.

Constitution and Statutes Involved.

CONSTITUTION OF THE UNITED STATES:

> Sixteenth Amendment.—The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

INTERNAL REVENUE CODE:

SECTION 22—Gross Income—

> (a) General Definition—"Gross income" includes, gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

SECTION 111—Determination of Amount of, and Recognition of, Gain or Loss—

> (a) Computation of Gain or Loss—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * * and the loss shall be the excess of the adjusted basis * * * over the amount realized.
>
> (c) Recognition of Gain or Loss—In the case of a sale or exchange, the extent to which the gain

or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

SECTION 112—Recognition of Gain or Loss—

(a) General Rule—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind—

(2) Stock for stock of same corporation—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) Stock for stock on reorganization—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(c) Gain from Exchanges not Solely in Kind—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5), * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph * * * to be received without the recognition of gain, but also of other property or money, then the gain, if any, to

the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from Exchanges Not Solely in Kind—If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(g) Definition of Reorganization—As used in this section (other than subsection (b) (10) and subsection (1)) and in section 113 (other than subsection (a) (22)).—

(1) The term "reorganization" means * * *
(E) a recapitalization * * *.

SECTION 115—Distributions by Corporations—

(a) Definition of Dividend—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) Source of Distributions—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and

from the most recently accumulated earnings or profits.

(c) Distributions in Liquidation—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112.

(g) Redemption of Stock—If a corporation cancels or redeems its stock * * * at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

SECTION 117—Capital Gains and Losses—

(b) Percentage Taken Into Account—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income.

* * * 50 per centum if the capital asset has been held for more than 6 months.

REVISED STATUTES OF NEW JERSEY:

Title 14, Chapter 8, Section 19:

The directors of a corporation shall not pay dividends except from its surplus * * * or from the

net profits arising from the business of the corporation, nor shall they divide, withdraw, or in any way pay to the stockholders or any of them, any part of the capital stock of the corporation or reduce its capital stock except as authorized by law.

In case of any willful or negligent violation of the provisions of this section, the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large upon the minutes at the time, or who, not then being present, shall have caused their dissent therefrom to be so entered upon learning of such action, shall jointly and severally be liable, at any time within six years after paying such dividend, to the stockholders, severally and respectively, to the full amount of any loss sustained by such stockholders, or in case of insolvency, to the corporation or its receiver to the full amount of any loss sustained by the corporation, by reasons of such withdrawal, division or reduction.

Title 14, Chapter 11, Section 1:

Any corporation * * * may, in the manner provided by section 14;1-2 of this title:

1. Change stock with par value, of any class or classes, into stock without par value of the same or of a different class or classes; * * *

Title 14, Chapter 11, Section 2:

The board of directors shall pass a resolution declaring that such amendment, change or alteration is advisable and calling a meeting of the stockholders to take action thereon. The meeting shall be held upon such notice as the by-laws provide, and in the absence of such provision, upon ten days' notice given personally or by mail.

If two-thirds in interest of each class of stockholders having voting powers shall vote in favor of such amendment, change or alteration, the corporation shall make a certificate thereof under its seal and the hands of its president or vice president and secretary or assistant secretary, which certificate shall be acknowledged or proved as in the case of deeds of real estate, and shall be filed in the office of the secretary of state.

Thereupon the certificate of incorporation shall be deemed to be amended accordingly, except that such certificate of amendment, change or alteration shall contain only such provision as it would be lawful to insert in an original certificate of incorporation made at the time of making such amendment, change or alteration.

The certificate of the secretary of state that such certificate has been filed in his office shall be taken and accepted as evidence of such amendment, change or alteration, in all courts and places.